



Moody's Investors Service

Global Credit Research

Rating Update

15 MAY 2001

Rating Update: **California (State of)****MOODY'S LOWERS STATE OF CALIFORNIA GO BOND RATING TO Aa3 FROM Aa2****\$25.5 Billion in Debt Affected. Outlook Remains Negative**State
CA**Opinion**

NEW YORK, May 15, 2001 -- Moody's has lowered the rating on \$19.8 billion of State of California General Obligation bonds to Aa3 from Aa2. In addition, we have lowered the rating on \$5.7 billion in lease revenue bonds from Aa3 to A1.

The downgrade reflects increasing financial risks associated with the continuing energy crisis, as well as those related to trends in the broader U.S. and California economies. The recent setback in securing legislation to provide energy purchase bridge financing threatens to compound the risks and cost of the energy crisis. In addition, the newly released May Revision to the Governor's Budget Submission confirms the substantial revenue deterioration that is expected to emerge over the next eighteen months due to the weak high technology sector and stock market. The May Revision commences what is likely to be a difficult budget debate.

Delay in External Energy Financing Will Continue to Erode State Financial Position

To date, the state's general fund cash advances for power purchases total approximately \$4 billion, and these advances are likely to grow very quickly in the coming months. Last week, the legislature passed a bill (Senate Bill 31) authorizing the issuance of \$13.4 billion in revenue bonds to fund future purchases and repay the General Fund for past advances. Unfortunately, this law will not go into effect until late summer, thereby scuttling the state's planned interim loan facility which would have provided temporary funding for power purchases. Importantly, the bridge financing would have begun the process of shifting the source of cash from the state treasury to the credit markets, and ultimately to ratepayers. That process is now delayed, and in the interim, the state treasury will continue to serve as the source of funds for power purchases.

Net state power purchase advances are running at the rate of over \$1 billion per month. Moody's estimates that the state's ending cash position will be approximately \$10 billion at June 30, 2001, including both General Fund cash and internal "borrowable resources", which represents cash that can be borrowed by the General Fund beyond the end of the fiscal year. This estimate takes into account expected energy purchases through June 30th.

In July and August, an additional \$3 to \$4 billion could be expended from the state treasury to purchase power until external financing is secured, bringing total General Fund advances for power purchases to almost \$10 billion by mid-August. As a result, the state's cash reserves are likely to be significantly depleted by the time long-term financing can be secured. The experience of the early 1990s indicates that a substantial portion of borrowable resources serve as a source of liquidity. Nevertheless, Moody's still anticipates this weakened cash position will lead the state to seek external cash flow borrowing for the General Fund in the form of Revenue Anticipation Notes during 2002, reversing the trend over the last two fiscal years in which the State has not needed to borrow externally for seasonal cash flow purposes. The state is expected to release refined cash projections later this week.

Although the state's liquidity position is clearly weakening, we do not view the state's current financial outlook as severe enough to lower the rating to the A range. And Senate Bill 31 protects the General Fund from future energy-related advances by stipulating that after November 15, 2001, the amounts required for short-term cash flow power purchases cannot exceed \$500 million in the aggregate. The enacted bill further

requires that such amounts be repaid from the Department of Water Resources Electric Power Fund within 180 days. These provisions provide some assurances that DWR will seek rate increases to fund its purchases when bond proceeds have been depleted. We are currently assuming the state's General Fund may not be fully reimbursed by the proceeds of the long-term financing, as such full reimbursement would reduce the amount of bond proceeds available for future power purchases, and require DWR to seek additional rate increases during 2001. Given the lack of consensus as to how to distribute the cost of power between ratepayers and the state treasury, it is unclear whether additional rate increases during 2001 will be politically feasible.

May Revision Quantifies Expected Deterioration in Revenue Forecast

As expected, the May Revision to the Governor's Fiscal 2002 Budget Submission revised tax revenue forecasts downward by a substantial magnitude, reflecting the economic and revenue effect of the weakening economic outlook compared to that underlying the Governor's January proposal. In particular, the weakening U.S. economic outlook and stock market performance, particularly in the technology-oriented NASDAQ market, produce major changes to the income and sales tax forecasts. Over the last several years, the percentage of General Fund revenues attributable to capital gains and stock options has grown from approximately 5% in fiscal 1996 to an estimated 23% in the current fiscal year. Based primarily on the downturn in the high technology sector, which relies heavily on options in compensation packages, and the sluggish performance of the stock market and its adverse affect on capital gains, the state has reduced its tax revenue estimate for the upcoming year by approximately \$5.4 billion, including a \$2.7 downward revision in the personal income tax. The drop in these sources of income will also temper growth in sales tax collections for the upcoming year. In total, the state now expects revenues to decline by approximately \$3.2 billion year over year between the current fiscal year and fiscal 2002. The state has not seen year over year tax revenue declines since 1992.

A number of budgetary actions taken in recent years will aid the state in adapting to the weaker revenue forecast. During fiscal 2001, as well as in the January proposal for 2002, the budget included substantial non-recurring spending items. As a result the base of recurring budget demands in fiscal 2002 and beyond is lower than it otherwise would have been. The governor has proposed to cancel or defer some of these items, seeking to reduce General Fund spending by approximately \$3.2 billion as compared to the January proposal. Spending cuts, however, do not match the revenue decline. Fiscal 2002 spending is slated to drop by \$600 million year on year, a drop of less than 1%, while revenues are expected to fall by 4% during the same period. Although the revenue forecast is relatively cautious, the target ending balance, at \$1.8 billion, leaves little cushion for additional bad news.

The proposed budgetary reductions, along with proposed spending levels for recurring items such as education, will likely lead to prolonged budget debate in the coming weeks. While such budget negotiations would not necessarily adversely affect the timing of the issuance of the long-term power bonds, delay could further weaken the state's fiscal position.

Energy Crisis Compounds Uncertainty in Economic Outlook

The energy crisis will have economic, as well as financial, consequences that add further uncertainty to an already complex economic outlook. The Governor's economic forecast calls for the economy to slow through 2002, taking a similar if not more slightly pessimistic view than other economists, including UCLA, Economy.com, and the economists surveyed by the Western Blue Chip. The state posted non-farm employment gains of nearly 4% in 2000, but the Governor's forecast expects job growth to moderate to 2.3% in 2001, and grow by less than 2% in 2002. Salary and wage income growth, which drives tax revenues, is expected to be even weaker than employment trends. The drivers of the forecasts include the outlook for the high technology sector, as well as the important housing sector.

None of the economic forecasts explicitly quantifies the impact of the energy crisis. The California economy is not heavily dependent upon energy, and ranks lowest among states in terms of per capita electricity consumption. The industries that drive the California economy are not heavy users of energy and it is not a major cost factor for the California industry mix. However, uncertainty regarding cost and availability of energy and the threat of unreliable power going forward have already damaged the state's business climate, reputation, and longer-term growth prospects. In Moody's view, the forecasting techniques of the major economic services tend to underestimate the potential impact of these difficult to quantify dimensions of the energy crisis.

Outlook

Outlook Remains Negative

At the moment, we expect that the substantial cash resources accumulated by the State of California during the expansion of the last decade, in combination with the planned long-term energy financing will enable it to avert the degree of fiscal damage that would call for the rating to fall to the A range. If a reasonably cautious balanced budget is enacted and the long-term energy financing completed, the state will still have reasonable margins of bondholder protection on its balance sheet. However, if the state or US economic outlook weakens further, or if the energy financing stalls, or if the enacted budget is only narrowly balanced, the rating could be adjusted further. While we expect that the state will be able to structure a viable long-term energy financing over the next few months, substantial obstacles must be overcome to meet that goal. In addition, the state will need to enact a balanced budget that leaves enough cushion to accommodate the remaining economic uncertainty not captured in its cautious revenue forecast. Given the recent failure to secure the supermajority necessary to enact emergency bridge energy financing legislation, we expect that the budget - which also requires a two-thirds majority vote - will also be the subject of a difficult debate.

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